

**REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION**

January 31, 2006

Dear Mr. Secretary:

Since the Committee's last meeting in November, economic releases continue to show the impact of record energy prices in the wake of Hurricane Katrina. For the year, 2005 GDP growth was near its long-term trend of 3.2%, even though it ended the year with weak 1.1% growth in Q4. Much of this decline was due to a sharp drop-off in automobile purchases, which followed a rise in such purchases in Q3 due to massive discounting. Despite the weakest consumption growth since Q2 2001, investment spending continued to expand, supported by investment in capital equipment. Going forward, moderation in home sales from their peak has the potential to subtract from residential investment growth and bring GDP growth below trend, but businesses' strong cash position should enable capital spending to move ahead moderately.

Employment rebounded from weak job gains post-Katrina during September and October. In the last two months of 2006, the economy added 413,000 jobs, just below the 425,000 jobs added in the months before Hurricane Katrina. In addition, the unemployment rate has reached a cyclical low of 4.9%, leading some, including the FOMC, to worry about the potential impact on inflation from tighter labor markets. However, wage gains remain tame, with average hourly earnings ending 2005 just 3.1% above the previous year. In addition, taking into account the impact of record energy prices, real disposable income ended the year just 0.4% above the previous year.

Although energy prices moderated following the hurricanes, they have begun to rise in 2006 due to instability in foreign oil-producing countries. Headline CPI inflation ended 2005 at 3.4% down from its peak of 4.7% in September. Price increases outside of energy were modest. The Fed's favored measure of inflation, the core PCE deflator, increased at a 2.2% annualized pace in Q4, putting its year-over-year (Y/Y) change in Q4 to 1.9%. The pass-through of higher energy prices and tight labor markets raise the risk that increases in core inflation may lie ahead. However, with energy prices unlikely to increase as drastically as they did in 2005, headline inflation will likely moderate in 2006. Foreign demand looks to have little impact on inflation, as the trade-weighted dollar remains close to its year-ago level.

After rising before the first FOMC tightening in June 2004, long-term Treasury yields have declined almost 50 bps since this tightening cycle began. As the FOMC increased its short-term target by 350 bps, the yield curve has flattened substantially, even

compared to previous tightening cycles of 1994 and 1999. A flat or inverted yield curve is a historically rare occurrence and is weighing on the Financials sector. Two-year yields and 10-year yields have now converged, as two-year yields are nearly 300 bps higher than the lows observed in mid-March 2004, while 10-year yields have risen only 75 bps. The market is currently pricing in just above an 80% probability that the FOMC will raise rates by 25 basis points at its March 28 meeting.

Corporate profits continue to rise. As of January 31, with slightly more than half of S&P 500 companies reporting, 79% had met or exceeded expectations for the fourth quarter.

The fiscal year (FY) 2005 deficit fell to \$319 billion, the lowest deficit since FY 2002. However, the hurricanes have reversed the improving trend in the federal deficit, a result of both reconstruction spending and lower receipts due to job losses. Assuming half of the \$62 billion appropriated for reconstruction is spent in FY 2006 and adding that to the CBO's baseline budget projection, the FY 2006 deficit will likely be \$345 billion (2.7% of GDP), in line with OMB projections and a slight worsening in the government's budget position. The Treasury will easily be able to finance this slightly higher budget deficit with its current financing schedule.

In the first section of the charge, Treasury asked the Committee for its views regarding the development of guidelines on the composition of the debt portfolio. Specifically, is the composition of bills relative to coupon securities in the appropriate balance at current levels of issuance? What other factors should Treasury use in its determination of debt portfolio composition?

Treasury presented the Committee with charts describing the flexibility, capacity and cost characteristics of bill financing. Characteristics of coupon financing were also shown including interest cost volatility, rollover risk, operational risk and investor base considerations. Additionally, charts demonstrating bill issuance as a percentage of total marketable outstandings, distribution of bills versus coupons, interest rate differentials across the maturity curve and average maturity of outstandings were presented. Committee members discussed numerous portfolio considerations and the viability or attractiveness of managing debt issuance around specific guidelines, including average maturity or bills as a percentage of total outstandings. While some felt that more specific guidelines might be worthwhile, others cautioned against this and proposed having a list of considerations to manage against without giving up Treasury's current issuance flexibility. These considerations included interest cost and volatility over time, issue size and auction frequency capacity, liquidity, responsiveness to the investor base and rollover risk. One member suggested to Treasury that it conduct further statistical analysis of its portfolio to determine an optimal barbell strategy to balance long-duration issuance and bills. In general most members favored a focus on average maturity of the debt while maintaining a relatively high percentage of bills as guiding principles for the objective of achieving the lowest cost of borrowing over time.

In the second part of the charge, Treasury asked for the Committee's views on resumed issuance of the 30-year bond. In particular they asked for the Committee's views on

future auction sizes, potential impacts on the STRIPS market and the desirability of quarterly issuance. Treasury did not indicate when they would offer guidance as to what amounts of issuance they plan in bonds but indicated maintaining similar amounts of issuance through 2007. Committee members differed as to preference of auction size, though many thought that there was strong enough demand to accommodate auction sizes near \$15 billion. Others thought that a more gradual approach to reintroduction would result in lower borrowing costs. These members suggested that the underwriting process may need some time to form and that Dutch auctions of long duration instruments may be initially an obstacle for market participants. Similarly, another member suggested that Treasury consider auction taps periodically as is common practice in the U.K. The Committee strongly preferred consideration of cycles which included auctions held in both May and November citing stronger stripping demand historically for bonds auctioned at that time of year. One member suggested auctions in February and August this year followed by May and November auctions in 2007. Members also encouraged Treasury to be sensitive to potential shortages of coupon STRIPS as they consider auction cycles as well.

In the third section of the charge, Treasury asked for the Committee's views with regard to relevance of yield curve shape at current levels, on the financial markets and the various types of participants within the broad industry group. A member responded to Treasury's pre-assigned charge which is appended to this letter. The member's response to the charge was organized in two basic parts: a discussion of the shape of the curve's impact on the general economy and its predictive ability of real output, and an analysis of the yield curve's shape on a variety of types of institutions. The member began his presentation by citing a reduced impact on the real economy from very flat yield curves than had been observed in the 1980's. He showed slides suggesting a coincidence of recessions with flat yield curves but noted that correlations between the two had diminished over time. Other members described a flat or inverted yield curve as a necessary but not sufficient predictor of economic slowdown. The presenting member showed slides depicting an increasing burden of financial obligations of homeowners due to the increase in short rates and higher incidence of adjustable rate mortgages. In general, while not minimizing the large increase in leverage of homeowners and associated debt service, the member felt that the yield curve at current shape and level may facilitate a shift in preference from shorter-term borrowing to long. Other members concurred with this view, describing consumers as efficient borrowers. The presenting member then turned to a discussion of a variety of financial market participants and the impact of the curve on their operating businesses. For the insurance industry as a whole, he cited increased pressure on earnings as yield spreads have contracted and long Treasury yields declined. The result has been pressure on earnings and a greater reliance on lesser credits and structured credit products, sacrificing liquidity for yield. Turning to the banking sector, the member showed slides illustrating a decline in net interest margins associated with both secular earnings trends and a flat yield curve. In general he felt that the larger banking institutions had and would be able to withstand the earnings pressures as their sources of revenues had been diversified by fee income. While larger banks still enjoy reasonable loan growth, and the efficiencies of a consolidated industry, the shape of the curve will pressure earnings. Lastly, the presenting member discussed the impact

of a flatter curve on the hedge fund industry noting that increased risk tolerance was observed in many participants and that risk in illiquid markets was growing as a result of fewer opportunities in the yield curve. Members discussed the increased exposure in riskier asset classes as common, which represents a tradeoff of liquidity for returns by a majority of investors.

In the last section of the charge, the Committee considered the composition of marketable financing for the January-March quarter to refund \$17.3 billion of privately held notes and bonds maturing on February 15, 2006, as well as the composition of Treasury marketable financing for the remainder of the January-March quarter and the April-June 2006 quarter. To refund \$17.3 billion of privately held notes and bonds maturing February 15, 2006, the Committee recommended a \$20 billion 3-year note maturing February 15, 2009, a \$13 billion 10-year note due February 15, 2016, and a \$15 billion 30-year bond due February 15, 2036. For the remainder of the quarter, the Committee recommended a \$22 billion 2-year note issued in February, a \$15 billion 5-year note issued in February, an \$8 billion reopening of the 10-year note issued in March, a \$22 billion 2-year note issued in March, and a \$15 billion 5-year note issued in March. The Committee also recommended a \$20 billion 13-day cash management bill issued on March 2, 2006 and maturing on March 15, 2006. For the April-June quarter, the Committee recommended financing as found in the attached table. Relevant features include three 2-year note issuances monthly, one 3-year note issuance in May, three 5-year note issuances monthly, a 10-year issuance in May with a June reopening, a 10-year TIPS reopening in April and a 5-year TIPS issue in April.

Respectfully submitted,

Ian G. Banwell
Chairman

Thomas G. Maheras
Vice Chairman

Attachments (2)